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Supreme Court of the United States

OCTOBER TERM, 1962

No. 1025

DIXIE MACHINE WELDING & METAL WORKS, INC.,
Petitioner

versus

UNITED STATES OF AMERICA,
Respondent

PETITION FOR CERTIORARI TO THE COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Supreme Court of the United States

OCTOBER TERM, 1962

No.

DIXIE MACHINE WELDING & METAL WORKS, INC.,
Petitioner

versus

UNITED STATES OF AMERICA,
Respondent

PETITION FOR CERTIORARI TO THE COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner seeks certiorari to review the judgment of the Court of Appeals for the Fifth Circuit, affirming disallowance of petitioner's income-tax deduction of certain expense payments on the ground that petitioner's evidence did not rebut the presumptive correctness of the Commissioner's determination that the payments were made in violation of a State penal statute; and, in support of its petition, respectfully shows:

Opinions Below and Jurisdiction

The District Court's opinion is reported at 207 Fed. Supp. 84. That of the Court of Appeals has not yet

been reported. Both opinions are printed in the Appendix hereto

The judgment of the Court of Appeals is dated March 21, 1963, and was entered on the same date. Jurisdiction of this Court lies under 28 USC 1254(1).

Question Presented

Whether a ship-repair yard may be denied an income-tax deduction for customary commissions which it and all other repair yards have to pay to the officers of foreign-flag ships to obtain repair work on such ships, and which are accordingly ordinary and necessary expenses of the taxpayer's business, on the ground that the taxpayer failed to discharge the burden of proving its innocence of crime in making the payments, as against the Commissioner's accusation that the payments violated (because, assertedly, they were made without the knowledge and consent of the shipowners) a Louisiana penal statute (the State's Commercial Bribery Law) never construed by any Louisiana Court, and for violation of which neither the taxpayer nor anyone else has ever been prosecuted.

Disallowance of these deductions, on the ground that the taxpayer failed to disprove the Commissioner's assertion that the expense payments were illegal, appears to conflict with this Court's holding in *Commissioner vs. Sullivan*, 356 US 27 (1958), the holding by another panel of the Fifth Circuit in *Commissioner vs Guminski*, 198 F2d 265 (1952), the Court of Claims'

holding in *Paramount Finance Co. vs United States*, 304 F2d 460 (1962), the Sixth Circuit's holding in *Lashells' Estate vs Commissioner*, 208 F2d 430 (1953), and the Tax Court's holdings in *Marlen E. Pew, Jr.*, 30 P-H TC Memo. Dec. 1505 (1961), and other cases; but is supported by the Tenth Circuit's holdings in *United States vs Winters*, 261 F2d 675 (1958), and *Finley vs Commissioner*, 255 F2d 128 (1958), and also appears to find support in a *dictum* in this Court's opinion in *Tank Truck Rentals vs Commissioner*, 356 US 30, 35 (1958).

In placing on the taxpayer, without statutory authority, the burden of exculpating itself from a charge of criminality in order to obtain allowance of a tax deduction, the decision below also raises serious questions under this Court's holdings in *Kennedy vs Mendoza-Martinez*, 372 US 144 (1963), and *Speiser vs Randall*, 357 US 513 (1958).

These questions are particularly crucial in light of the denial to the taxpayer in this case, of a deduction which had in other cases uniformly been allowed on the finding that the ship-supply taxpayers in those cases had discharged the burden of proving their innocence of crime in making payments of the same character in the same circumstances as those here at issue. See cases and rulings cited on page 8 below.

Statutes Involved

"In computing net income there shall be allowed as deductions: . . . All the ordinary and necessary ex-

penses paid or incurred during the taxable year in carrying on any trade or business . . ."

Internal Revenue Code (1939), section 23(a)(1)(A); 26 USC 23(a)(1)(A); 53 Stat. 12. (The corresponding provision of the 1954 Internal Revenue Code is substantially the same.)

"Commercial bribery is the giving or offering to give, directly or indirectly, anything of apparent present or prospective value to any private agent, employee, or fiduciary, without the knowledge and consent of the principal or employer, with the intent to influence such agent's, employee's, or fiduciary's action in relation to the principal's or employer's affairs.

• • •

"Whoever commits the crime of commercial bribery shall be fined not more than five hundred dollars, or imprisoned for not more than one year, or both."

Louisiana Revised Statutes, Title 14, Section 73; 9 West's Louisiana Statutes Annotated—Revised Statutes 442-43.

Statement of the Case

This suit for refund of income taxes was filed following disallowance, by the Internal Revenue Service, of deductions claimed by the petitioner-taxpayer for commissions which it paid to the masters and chief engineers of foreign-flag ships repaired in its ship-repair yard in New Orleans.

The taxpayer's evidence shows that there is a long-standing custom among ship-repair companies, as

among ship chandlers, stevedores, fuel suppliers, tug companies, charterers, steamship agents, etc., to pay a commission (5% to 10%, net, of the amount of the bill, depending on the business involved) to the officers of the foreign vessels with which they deal. R 52, 55-56, 58-59, 137-39, 148-50, 163-65, 168-69, 181, 196-98, 204-205, 218, 229-30, 232-34, 238-39, 256-57, 260-61, 264-65, 275, 284-85, 293, 324-27, 336, 345, 359, 371, 373-74, 377, 381-82, 385, 388-89, 392, 394, 396, 399.

Petitioner makes these payments for two reasons: First, since all repair yards make the payments, any yard which did not make them would get no work on foreign-flag ships. R 56, 59, 142-43, 152, 167, 171-72, 174-75, 197, 258-59, 230-33, 239-40, 330, 335-36, 362-63. Second, the payments are made in consideration of assistance rendered to the repair company by the vessel's officers and crew in co-ordinating loading and unloading operations with the repair work, in furnishing steam and electric power, in translating blueprints in foreign languages, in furnishing special tools for the ship's engines and equipment, in expediting repair operations through familiarity with the layout of the ship's equipment, engines, switches, connections, valves and switchboards, in assisting in dismantling, removal, re-assembly and replacement of equipment to be repaired, and in cleaning up after the repairmen. R 52, 55-56, 58-59, 136-37, 167, 195-96, 228-29, 255-56, 266, 273-75, 322-23, 358-59, 371, 374-75, 382, 396.

Pursuant to this custom, the taxpayer made such payments to masters and chief engineers of foreign

ships during its fiscal years ended June 30, 1951 and 1952. As it always has, the taxpayer entered the payments openly on its books, and withheld, and remitted to the United States Government, all federal withholding taxes due on the payments. R 70-72.

As it always had in previous years, the taxpayer deducted these payments in computing its federal income-tax liability for the years at issue. Although such deductions had been allowed in all previous years, the Internal Revenue Service disallowed the deductions for 1951 and 1952, on the ground that the payments were against public policy. Later the Government modified its position by asserting that the payments were violative of Louisiana's Commercial Bribery Law, a criminal statute (quoted on page 4 above).

In the 43 years that this Commercial Bribery Law has been on the statute books (see Louisiana Act 108 of 1920), no prosecution has ever been instituted under it.

The taxpayer paid the additional taxes assessed upon disallowance of the deductions, and filed this suit for refund in the United States District Court in New Orleans. R 6-7.

In the District Court, the taxpayer presented substantial evidence that the payments did not violate the State law because (1) they were made pursuant to a custom of which the foreign shipowners were

aware, and in which they acquiesced, and (2) since all repair yards pay the commissions, the taxpayer's payments could not be considered made to influence the shipmasters to give work to it, but were made simply to be sure that it would receive the same consideration as other shipyards in the award of repair work, the payments being conditions, not causes, of the award.

In addition to presenting testimony as to shipowner knowledge of the customary payments, the taxpayer brought to the District Court's attention the fact that the existence and universality of the custom has been recognized by the Governments of the United States and Norway;[1] and that, in an unbroken series of cases and rulings involving deductibility of commissions paid by ship chandlers to foreign ships' officers pursuant to the identical custom, the payments had always been held to be deductible, on the finding that they

[1] See *Rev. Rul. 58-479*, 1958-2 CB 60 ("Such custom prevails not only in all of the larger coastal ports of the United States, but also throughout the world"; "the practice is known to the shipowners and is recognized as a legitimate means of supplementing the relatively small salary of the foreign shipmaster"); Commissioner of Internal Revenue, Letter Ruling, March 14, 1957 (quoted in the Appendix hereto, page 69 below) ("The custom of paying the commission is well known to foreign shipowners"); War Shipping Administration, Food Control Regulation No. 3 (1943) [This regulation, which prohibited the payments as to vessels operated with lend-lease funds, was revoked at the close of the war. See *Eugene Richardson*, 26 P-H TC Memo. Dec. 439, 442 (1957), assessment of fraud penalties rev'd, 264 F2d 400]; (Norwegian) Board of Internal Revenue, Circular No. 117 (1952) ("It is common practice for ship repair yards to pay remuneration to shipmasters and other officers of vessels undergoing repairs at shipyards. . . . 'it is commonly known that officers of ships receive remuneration as stated' "), R 611-13.

were made with the shipowners' knowledge and consent, and therefore did not violate any commercial-bribery law. *Fiambolis vs United States*, 152 FS 10 (ED SC-1957); *Eugene Richardson*, 26 P-H TC Memo. Dec. 439 (1957), assessment of fraud penalties rev'd, 264 F2d 400 (CA 4); *Frank J. Valetti*, 28 TC 692 (1957), assessment of fraud penalties rev'd, 260 F2d 185 (CA 3); Commissioner of Internal Revenue, Letter Ruling, March 14, 1957 (quoted in the Appendix hereto, page 69 below); *Rev. Rul.* 58-479, 1958-2 CB 60. (The commercial-bribery argument was rejected in *Fiambolis* and *Richardson*, and was not raised in *Valetti* or discussed in the cited rulings.)

The Government countered with testimony which was designed to show lack of shipowner knowledge and consent. This testimony was in some instances inconsistent. (Some of the Government's shipowner witnesses flatly denied the existence of the custom of making the payment—others freely admitted the existence of the custom, denying only that they acquiesced in it.) In other instances, it was incredible. (The only Government witnesses who denied the existence of the custom of making the payments, were three Norwegian shipowners. As noted in footnote 1 above, the Government of Norway has officially recognized the existence of this custom.) The evidence of both the taxpayer and the Government is summarized in the Appendix hereto, at page 63 below.

After consideration of the evidence, the District Court concluded that "it cannot be said that plain-

tiff taxpayer has clearly established by a preponderance of the evidence that the practice is universal or known to the owners of the ships repaired by it". R 648; 207 FS at 86-87. The Court held that, accordingly, "the transaction is clearly prohibited by the Louisiana Commercial Bribery Statute and we cannot give our sanction to it". R 651-52; 207 FS at 88. Judgment was entered dismissing the action. R 653.

In affirming this judgment, the Court of Appeals held that the District Court's finding, that the taxpayer had failed to discharge its burden of proving shipowner knowledge of the customary payments, was not clearly erroneous, and hence could not be reversed. The Court of Appeals then approved the District Court's holding that, failing such proof, the payments violated Louisiana's Commercial Bribery Law. In the absence of any construction of that Law by any Louisiana court (since the Law had never before been invoked in its 43 years of existence), the Court of Appeals supplied its own broad construction of the Law on an important disputed point, as a matter of novel impression.[2]

[2] The Law proscribes payments made "without the knowledge and consent" of the recipient's employer. Many of the Government's shipowner witnesses admitted their knowledge of the customary payments, but denied that they consented thereto. See Appendix, page 66 below. Under accepted usage, the construction "without", followed by two nouns joined by "and", implies the absence of both; "without falsehood and deceit" means "without falsehood and without deceit". Fowler, *A Dictionary of Modern English Usage* (1937) 408 (under OR 4). Under this accepted usage, Louisiana's Law would not be violated by payments made with either the knowledge or the consent of the employer. This interpretation is also supported by the rule of strict construction of penal statutes, to which Louisiana adheres (Note, 20 Lou-

Finally, the Court of Appeals held that the payments, being violative of state law, are not deductible for federal income-tax purposes. The Court distinguished the prior cases in which such payments by ship chandlers had uniformly been held to be deductible, on the ground that, in each of those cases, it had been found as a fact that the foreign shipowners either "actually approved of" the payments, or were at least "aware of this practice". R 17-18; Appendix, page 48 below. (As noted in footnote 2 above, however, the Court also held that mere proof of shipowner knowledge of the custom would not have made the payments in this case deductible, but that the taxpayer had the additional burden of proving shipowner consent to the payments as well.)

The Court of Appeals recognized that this Court, in *Commissioner vs Sullivan*, 356 US 27, had sustained the deductibility of payments found illegal under state law; but concluded that this holding was qualified by a *dictum* in the opinion handed down the same day in *Tank Truck Rentals vs Commissioner*, 356 US 30, 35 ("Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute").

isiana Law Review 600 (1960)), and by the recognized purpose of commercial-bribery laws, which are aimed primarily at payments made without the employer's knowledge, since the employer, if aware of the payments, is in a position to protect his own interests. However, the Court of Appeals held, without discussion or citation of authority, that the Louisiana Law was violated if the taxpayer could not prove both employer knowledge of, and employer consent to, the payments. R 671; Appendix, page 41 below.

The Court of Appeals reconciled the *Sullivan* holding with the *Tank Truck* dictum by pointing out that the *Sullivan* payments were violative only of "the general provisions of the aiding and abetting statute" of Illinois, not a "specific statute or language making it a crime for a gambler to pay his wages or his rent". The Court found a greater degree of "specificity of proscription" in the Louisiana Commercial Bribery, than in the Illinois aiding and abetting, statute; determined that "the state policy in the one instance is not as 'sharply defined' as in the other"; and held that the *Sullivan* holding is therefore inapplicable in this case. R 18-20; Appendix, pages 48-51 below.

The taxpayer had cited to the Court of Appeals its own decision (by another panel) in *Commissioner vs Giaminski*, 198 F2d 265, the decision of the Court of Claims in *Paramount Finance Company vs United States*, 304 F2d 460, and decisions of the Tax Court in *Marlen E. Pew, Jr.*, 30 P-H TC Memo. Dec. 1505, and other cases, in all of which, as in this Court's *Sullivan* decision, payments violative of law had been held to be deductible for tax purposes. The Court made no reference to any of these decisions in its opinion.

Argument

Few areas of federal tax law are so plagued with recurrent conflicts as the question of the extent to which an income-tax deduction may be denied on the ground that allowance of the deduction would frustrate public policy. This Court has deemed various

aspects of the question sufficiently important to warrant the grant of certiorari in 1941, 1943, 1952, 1958 (three cases) and 1959.[3]

Despite this Court's decisions, the proliferation of conflicting lower-court holdings has persisted. Most of the cases are collected in an Annotation: *Public Policy as Ground for Denying Deduction for Federal Income Tax Purposes*, 27 ALR2d 498 (1953), which is supplemented at 2 ALR2d Supplement Service (1960) 2221, 3 ALR2d Supplement Service (1962) 657, and January 1963 ALR2d Supplement Service 397.

This question is unusual among federal tax problems, in that the so-called "policy frustration doctrine" does not involve or stem from any provision of the Internal Revenue Code or any other federal statute. The doctrine is administratively conceived and judicially fashioned, not only without any basis in legislation, but actually in the face of the repeated refusal of Congress to endorse it by statutory enactment.[4]

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[3] *Textile Mills Corp. vs Commissioner*, 314 US 326 (1941); *Commissioner vs Heininger*, 320 US 467 (1943); *Lilly vs Commissioner*, 343 US 90 (1952); *Commissioner vs Sullivan*, 356 US 27 (1958); *Tank Truck Rentals vs Commissioner*, 356 US 30 (1958); *Hoover Motor Express Co. vs Commissioner*, 356 US 38 (1958); *Cammarano vs United States*, 358 US 498 (1959).

[4] Proposals to limit deductions to "lawful" or "legitimate" expenses were rejected when the income-tax law was first adopted in 1913, and have twice been rejected since. 50 Cong. Rec. 3849-50, 4613; Senate Report 781, 82d Cong., 1st Sess., p. 120; Section X165(i), American Law Institute draft Federal Income Tax Statute, proposed during compilation of the 1954 Internal Revenue Code. See Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, 1954 Major Tax Problems (Southern California Tax Institute) 715, 741-42; Note, 5 New York Law Forum 208, 211-12 (1959). "Both the words and the legislative history of the Internal

Perhaps the most vexed facet of the question is the aspect involved in this case—whether a deduction may be denied unless the taxpayer affirmatively disproves the Commissioner's assertion that he is guilty of a criminal offense, of which he has not only not been convicted, but with which he has never even been charged.

The lower-court decisions were in conflict before this Court first took up the question in 1958. The Fifth Circuit itself, among others, had sustained the deduction of excessive price payments made in violation of criminal price-ceiling regulations. *Commissioner vs Guminski*, 198 F2d 265 (1952).[5] The Sixth Circuit had sustained the exclusion from income of commissions paid by the taxpayer to a customer's purchasing agent, without the customer's knowledge, for business referred. *Lashells' Estate vs Commissioner*, 208 F2d 430.[6] The Tax Court had upheld the deductibility of

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Revenue Code indicate that Congress intended it as a method of collecting revenue proportionate to the net income of the taxpayer, and not as a method of suppressing sin". *The Supreme Court, 1951 Term*, 66 Harvard Law Review 89, 174 (1952).

[5] The Court wrote a memorandum opinion adopting the opinions in *Commissioner vs Weisman*, 197 F2d 221 (CA 1-1952); and *Hofferbert vs Anderson Oldsmobile, Inc.*, 197 F2d 504 (CA 4-1952). In *Hofferbert*, the Court held that "'the taxpayer cannot deny his receipt of income on the ground that it resulted from illegal transactions; but neither can the Commissioner find the existence of income where there is none, by reason of illegality'". 197 F2d at 507. In *Weisman*, the Court concluded that "the price control law provides sanctions for such violations and we are not convinced that Congress intended that they be supplemented by the tax laws in the manner suggested by the Commissioner here". 197 F2d at 223.

[6] Accounting distinctions, sometimes mentioned in opinions in the public-policy line, between "exclusions" and "deductions" from income, or between cost of goods and other expenses, are without relevance to the policy-frustration doc-

milk-price rebates made "in willful violation" of a criminal minimum-price law. *Pittsburgh Milk Co.*, 26 TC 707 (1956), app. dis., CA 3.

To the contrary, deductibility of payments had been denied on the ground of illegality by the Eighth Circuit (*Rugel vs Commissioner*, 127 F2d 393 (1942)), by the Tenth Circuit (*Harden Mortgage Loan Co. vs Commissioner*, 137 F2d 282 (1943)), and by the Tax Court in a number of cases, notably including a series of decisions disallowing bookmakers' payments of wages and rent in violation of a criminal statute of Illinois. *Sam Mesi*, 25 TC 513 (1955), rev'd, 242 F2d 558 (CA 7), aff'd, 356 US 27; *James Ross* and *Neil Sullivan*, 25 P-H TC Memo. Dec. 19 (1956), rev'd, 241 F2d 46 (CA 7), aff'd, 356 US 27.

The Seventh Circuit had reversed the Tax Court's "bookmaker" decisions on a theory it had evolved without regard to the legality of the payments, and this Court granted certiorari. Without disturbing the Tax Court's finding that "the payment of the wage in question in and of itself constituted an illegal act" (25 P-H TC Memo. Dec. at 23), this Court held that the payments were nonetheless deductible. Pointing

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fine. Keesling, *Illegal Transactions and the Income Tax*, 5 UCLA Law Review 26, 40-46 (1957); Note, 75 Harvard Law Review 1441 (1962). Any such distinction would be irrelevant in any event in this case, which involves deductibility of payments of the same type as those involved in the *Lashells* case and in *Eugene Richardson*, 26 P-H TC Memo. Dec. 439, 446 (1957), in which the payments were held to constitute "either ordinary and necessary business expenses . . . or adjustments of the sales prices set out in the invoices". See also *Marlen E. Pew, Jr.*, 30 P-H TC Memo. Dec. 1505 (1961).

out that Congress had evinced no "disapproval of these expenses as deductions", and that the payments were "ordinary and necessary expenses" in the accepted meaning of the words, this Court stated: "That is enough to permit the deduction, unless it is clear that the allowance is a device to avoid the *consequence* of violations of a law (citing cases denying deduction of legally assessed fines and penalties), or otherwise contravenes the *federal* policy expressed in a statute or regulation (citing a decision denying deduction of lobbying expenses under a specific income-tax regulation which had received Congressional approval)." *Commissioner vs Sullivan*, 356 US 27, 28, 29 (1958) (emphasis supplied).

This holding seems clear-cut enough to eliminate the conflict as to deductibility of payments assertedly violative of state law; but this result has not been achieved, because of an apparent inconsistency between the *Sullivan* holding, and a statement in another policy-frustration opinion handed down by this Court on the same day, in *Tank Truck Rentals vs Commissioner*, 356 US 30, 35 (1958).

In the *Tank Truck* case, this Court held that fines or penalties assessed for violations of State law are not deductible. In its discussion of the policy-frustration doctrine, this Court included the following statement (not necessary to its decision): "Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute." In support of this

statement, this Court cited only one case; of all the available lower-court decisions denying deductions on the ground of illegality, it chose for citation the only such case in which the taxpayer's violation of state law in making the payment had previously been properly determined by the state authority charged with enforcing the violated law: *Boyle, Flagg & Seaman, Inc.*, 25 TC 43, 46 (1955), in which, after a hearing by the proper state officials, a violation of the Illinois insurance code had been established.

The inconsistency (whether real or only apparent) between the *Sullivan* holding and the *Tank Truck dictum*, has been the subject of extended discussion by law-review writers, and the source of continued conflict in lower-court decisions. Most of the law-review commentators have, in light of the categorical nature of the *Sullivan* holding, concluded that deductions can no longer be denied on the ground of asserted illegality, despite the *Tank Truck dictum*, which they have distinguished in various ways. *Cf.* Paulston, *Public Policy in Deductibility of Business Expenses*, 1959 Major Tax Planning (Southern California Tax Institute) 467, 523; Comment: *Business Expenses, Disallowance, and Public Policy*, 72 Yale Law Journal 108, 116 (1962); Comment: *"Ordinary and Necessary and Legal Expenses"*, 25 University of Chicago Law Review 513, 519 (1958); Note, 5 New York Law Forum 208, 212 (1959); Note, 30 Mississippi Law Journal 337 (1959); Note, 43 Cornell Law Quarterly 725, 727 (1958).

Other law-review writers have, however, construed the *Tank Truck* and *Sullivan* decisions as expanding

the policy-frustration doctrine, and have postulated a restriction of the *Sullivan* holding to payments which are not "specifically mentioned in a state statute" as illegal. *Cf.* Crown, *Deductibility of Expenditures Offending Statutes or Regulations*, 17 NYU Institute on Federal Taxation 157 (1959); *The Supreme Court, 1957 Term*, 72 Harvard Law Review 77, 115-16 (1958).

The Court of Appeals for the Fifth Circuit adopted this latter view in affirming disallowance of deductions of assertedly illegal payments in the case at bar, R 18-20, Appendix, pages 48-51 below; and the Tenth Circuit has similarly taken the *Tank Truck dictum* as authority for denial of deductibility of payments violative of state liquor laws. *United States vs Winters*, 261 F2d 675 (1958); *Finley vs Commissioner*, 255 F2d 128 (1958).

But the Court of Appeals for the Third Circuit has read the *Tank Truck* and *Sullivan* opinions as indicating that "the tendency of that (this) Court is to limit the effect of the (policy) frustration doctrine", and has accordingly sustained the deduction of a payment in violation of a state law which provided only civil, not criminal, penalties. *Farnsworth vs Commissioner*, 270 F2d 660, 664 (1959).

In direct conflict with the holdings of the Fifth and Tenth Circuits, is that of the Court of Claims in *Paramount Finance Co. vs United States*, 304 F2d 460 (1962). In sustaining the deduction of "kickback" payments violative of a State statute, the

Court pointed out that "the Boyle, Flagg & Seaman case"—the only authority cited by this Court in support of its *Tank Truck dictum* condemning payments in violation of law—"contained an element lacking in the present action; *i. e.*, a determination, by the authority charged with the enforcement of the state or federal law or the carrying out of the public policy involved, that the expense for the deduction sought was incurred in violation of that law or well-defined public policy". The Court went on to hold that "lacking any such determination, we are of the opinion that an allegation by the Internal Revenue Service that the expense was incurred in violation of a state statute is insufficient to disallow an otherwise proper deduction unless the expense occasioned an act *malum in se*". 304 F2d at 463.

The Tax Court has similarly continued to uphold deductions of milk-price rebates made "in willful violation" of Pennsylvania's penal price-control law [*Atzingen-Whitehouse Dairy*, 36 TC 173 (1961); *Harmony Dairy Co.*, 29 P-H TC Memo. Dec. 651 (1960)]; and the same Court recently sustained the deduction of commissions paid by a public relations consultant to his client's advertising manager, admittedly without the client's knowledge or consent, for business referred. *Marlen E. Pew, Jr.*, 30 P-H TC Memo. Dec. 1505 (1961). The Commissioner's opposition to allowance of the deduction was based on the fact that the payments were in clear violation of New York's corrupt-influencing law (Penal Law, section 439), as set forth in the Government's brief in the case, although

this contention is not mentioned in the Tax Court's opinion.

In addition to presenting a direct conflict with these Court of Claims and Tax Court holdings, the Fifth Circuit's decision in the case at bar raises serious questions both within, and outside, the framework of the policy frustration doctrine.

Within the context of the doctrine, the question arises whether a State's public policy is really aided when the Internal Revenue Service suddenly undertakes to implement, by denial of tax deductions, the policy of a state statute which no state district attorney or grand jury has ever seen fit to enforce in the 43 years it has been on the books, especially when federal enforcement of the state law involves resolution of a close question of penal statutory construction as a matter of first impression, and takes the form of addition to the penalty prescribed in the

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"Except where inimical to the interests of some larger group . . . the desire of a community to enforce the (local) laws according to its needs and tolerances should be respected. When the responsible officials become aware of apparent offenses and tolerate them by refusing to invoke sanctions, the proscription in question is nominal, not effective, law; and enforcement by the IRS in such circumstances amounts to an arbitrary defeat of reasonable expectations." Comment: *Business Expenses, Disallowance, and Public Policy*, 72 Yale Law Journal 108, 130 (1962). "Most states have many statutes, e.g., 'Sunday blue laws,' which they do not wish to enforce. Enforcement of such laws through the federal tax would hardly aid state policy." Comment: *"Ordinary and Necessary and Legal Expenses"*, 25 University of Chicago Law Review 513, 521 (1958). In the circumstances of the case at bar, "it seems that the Court of Appeals, and not the State of [Louisiana], is determining what is against the public policy of the State". Note, 30 Mississippi Law Journal 337, 338 (1959). See *James G. Hoover*, 32 TC 618 (1959).

statute for violations thereof, of another, perhaps extraordinarily severe, penalty—loss of a tax deduction —which was certainly never contemplated by the state legislature when it enacted the statute.[8]

This question is all the more serious in that the deduction-denial method of implementing statutory policy is necessarily discriminatory and arbitrary in effect, since it depends, not on the gravity of the offense, but only on the amounts expended and the taxpayer's profit for the year;[9] and may, as in this case, result in assessment of a crushing tax penalty out of all proportion both to the nature of the offense and to the penalty therefor prescribed by statute.[10]

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[8] "When the Treasury disallows deductions of expenditures incurred in a proscribed activity, it thereby alters the response or set of responses deliberately chosen by the responsible agency which presumably will most justly and efficiently maximize formalized community values." Comment: *Business Expenses, Disallowance, and Public Policy*, 72 Yale Law Journal 108, 128 (1962). As noted in footnote 5 above, this concept was the basis for the First Circuit's reversal of the Commissioner's denial of deductions for over-ceiling price payments.

[9] The deduction-denial approach "distorts the usual state scheme of maximum penalties by in effect levying a fine which varies according to the amount of the expenditure and the criminal's income. Moreover, the automatic application of the rule may conflict with a state policy vesting discretion in the trial judge to establish the penalty for a particular violation." Note, 75 Harvard Law Review 1441, 1442 (1962). Accord: Comment: *Business Expenses, Disallowance, and Public Policy*, 72 Yale Law Journal 108, 126 (1962).

[10] Petitioner has been assessed with additional taxes of $110,968.59 for two tax years. R 7. The maximum fine applicable to corporate offenders under the Louisiana Commercial Bribery Law is $500. "The result of disallowance is often an arbitrary and harsh sanction as compared with those of the primary statute". Comment: *Business Expenses, Disallowance, and Public Policy*, 72 Yale Law Journal 108, 126 (1962). "Disallowance of the deduction may be far more burdensome financially than the punishment imposed by the state." Note, 75 Harvard Law Review 1441, 1442 (1962).

That these are not merely theoretical difficulties, is evidenced by the fact that this is by no means the first case in which the Internal Revenue Service has resurrected a dead-letter State law, to justify disallowance of a tax deduction. In 53 years of prohibition in Oklahoma, no one has yet been so much as prosecuted for violation of the liquor laws, and it may be assumed (at least from the number of tax decisions and rulings involving those laws) that they are generally disregarded.

Nonetheless, the federal tax authorities, with the endorsement of the Tenth Circuit, regularly deny deductions for the expense of wining customers in Oklahoma. In Pennsylvania, because of public hostility to that State's milk-control law passed at the behest of the dairy farmers, the Milk Control Board rarely prosecutes for criminal violations of the statute, which are rampant. But the Government regularly refused deductions for rebates violative of the law, until a series of Tax Court decisions rejected the public-policy argument in this area. See Comment: *Business Expenses, Disallowance, and Public Policy*, 72 Yale Law Journal 108, 125, 129-30 (1962).

More fundamental questions arise outside the framework of the policy-frustration doctrine. Prominent among these is the far-reaching effect of attempted enforcement by federal tax authorities of the policy

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Accord: Comment: *"Ordinary and Necessary and Legal Expenses"*, 25 University of Chicago Law Review 513, 521-22 (1958).

of state criminal statutes without Congressional authorization, on the distribution of law-enforcement powers between the federal and state governments. It has been suggested that this consideration was the real underlying premise for this Court's holding in *Commissioner vs Sullivan*;[11] and it was the determinative factor in the Court of Claims' rejection of the Commissioner's denial of deductions allegedly (but not determined by state authority to be) violative of state law, in *Paramount Finance Co. vs United States*, 304 F2d 460, 463 (1962): "To permit the Internal Revenue Service to employ Federal tax law in an effort to enforce its concept of state law as the Service views it,

[11] "It may be that the distinction between fines and other expenses implicit in the *Tank Truck* and *Sullivan* cases reflects this concern for federal-state relations. Thus disallowance of deductions for fines merely aids an enforcement which has already taken place, rather than constituting independent enforcement of state law." Comment: *"Ordinary and Necessary and Legal Expenses"*, 25 University of Chicago Law Review 513, 522 (1958). "A contrary holding in *Sullivan* would have had far reaching effects on the distribution of power between the federal and state governments over gambling and other illegal businesses. . . . Although the national government's invasion of areas of crime control traditionally reserved to the states is not unknown, such national interventions have generally rested upon specific congressional enactments . . . [and] are not designed directly to suppress activities illegal under state law, but to assist state enforcement agencies in the administration of their own statutes." Among the "many possible reasons why the [this] Court would not approve this change in the administration of the federal and state criminal systems", are that the elements of many crimes vary from State to State and are thus matters of primarily local concern; that federal tax enforcement of State laws tends to supersede the States' own responsibilities in that regard, and deprives the State authorities of their discretion in deciding which offenders are to be prosecuted and what sanctions are to be imposed; and that the Internal Revenue Service may not be suited to assume the duties of enforcing criminal laws outside the tax field. Comment: *Business Expenses, Disallowance, and Public Policy*, 72 Yale Law Journal 108, 140-41 (1962).

would be an unnecessary extension of its delegated authority, at the very best, and creates a disruptive atmosphere of interference by the Federal government in an area traditionally reserved to the states."

Of at least equal importance is the question arising from the fact that, by a mere accusation of criminality, the Internal Revenue Service has succeeded in this case, without Congressional authorization, in placing on the taxpayer the burden of proving itself innocent of the crime alleged to have been committed, in order to obtain a tax deduction to which it is plainly entitled under the terms of the revenue statute. Only last February, this Court again demonstrated its continuing concern with the application of ostensibly regulatory, but actually punitive, measures through procedures lacking the traditional safeguards of the rights of the accused. *Kennedy vs Mendoza-Martinez*, 372 US 144.

In *Speiser vs Randall*, 357 US 513 (1958), this Court held directly that the denial of a tax exemption for penal purposes may not be accomplished by placing on the taxpayer the burden of proving his innocence of crime. This decision was based on the holding, in *Lipke vs Lederer*, 259 US 557, 562 (1922), that when a tax has a punitive or deterrent, rather than a revenue-raising, purpose, it may not be collected by summary methods which exclude "the guarantees of due process".

There is no pretense that the policy-frustration doctrine forms any part of the revenue-raising scheme

of the Internal Revenue Code—a contention that could, in any event, scarcely be reconciled with Congress' repeated rejection of efforts to incorporate the doctrine in the Code. On the contrary, this Court has recognized expressly that the purpose of the doctrine is deterrent ("To allow the deduction here sought would but encourage continued violations of state law", *Tank Truck Rentals vs Commissioner*, 356 US at 35), and that its effect is punitive ("to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding, which Congress has not expressly or impliedly indicated should result from such a finding", *Commissioner vs Heininger*, 320 US at 474-75).[12]

Again, no mere theoretical problem is placed at issue by making allowance of a tax deduction contingent on the taxpayer's ability to exculpate himself from a criminal charge. In *Speiser vs Randall*, this Court found it a "commonplace that the outcome of a lawsuit—and hence the vindication of legal rights—depends more often on how the factfinder appraises the facts than on a disputed construction of a statute or interpretation of a line of precedents". 357 US at 520.

[12] Denial of a tax deduction for asserted violation of law "would raise the question of whether the taxpayer was being penalized for an alleged crime without a trial conducted under the safeguards of the Sixth Amendment". Comment: *"Ordinary and Necessary and Legal Expenses"*, 25 University of Chicago Law Review 513, 521 (1958). Accord: Paulston, *Public Policy in Deductibility of Business Expenses*, 1959 Major Tax Planning (Southern California Tax Institute) 467, 523.

In the case at bar, petitioner has been compelled to pay more than $100,000 of additional taxes because it was held not to have discharged the burden of proving shipowner knowledge and consent as to the customary payments at issue; whereas in all other cases involving deductibility of payments pursuant to the identical custom, the deductions have been allowed because the taxpayers' evidence of shipowner knowledge and consent was found sufficient to carry the burden of proof. See page 8 above.

All of the foregoing considerations were advanced by petitioner in the Court of Appeals, but none of them is discussed in the Court's opinion.

It should be added that none of these questions is involved in, much less foreclosed by, this Court's *Tank Truck* holding that fines and penalties are nondeductible. Disallowance of deduction of fines and penalties occurs only after enforcement of the state statute by the proper state officials under procedures appropriate to a determination of guilt. In such cases, the taxpayer has already been convicted under proper safeguards, and a penalty has been assessed against him in keeping with the policy of the statute and the due-process clause.

In such proceedings, no question can be raised that federal administrative authorities have undertaken the enforcement of a dead-letter state law, by placing on the taxpayer the burden of proving his innocence of an alleged criminal offense, under pain of an assess-

ment of tax penalties disproportionate to the offense and the statutory sanctions therefor. Denial of deduction of a penalty validly assessed, does no more than implement the enforcement of a state statute by state officials, by making sure that the offender bears the full penalty—neither less nor more—legally assessed against him under the state law pursuant to state determination of his guilt of violation thereof.[13]

Conclusion

The result reached by the Court of Appeals in this case is directly opposed to the result reached by this Court in *Commissioner vs Sullivan*, 356 US 27 (1958). In this case, deduction of payments was denied because the taxpayer failed to convince the District Court that they were not made in violation of a state law. In the *Sullivan* case, deduction of payments was allowed despite the fact that they were made in violation of a state law.

Some measure of the existent confusion as to the proper rule to be followed in this region of the law, is indicated by the fact that the Court of Appeals reached its conclusion, not in any spirit of defiance of this Court's authority, but in an effort to reconcile

[13] See *Tank Truck Rentals, vs Commissioner*, 356 US 30, 35-36 (1958); *Jerry Rossman Corp. vs Commissioner*, 175 F2d 711, 713 (CA 2-1949); Paulston, *Public Policy in Deductibility of Business Expenses*, 1959 Major Tax Planning (Southern California Tax Institute) 467, 523-24; Comment: *Business Expenses, Disallowance, and Public Policy*, 72 Yale Law Journal 108, 124-25 (1962); Comment: *"Ordinary and Necessary and Legal Expenses"*, 25 University of Chicago Law Review 513, 521 (1958); Note, 75 Harvard Law Review 1441, 1442 (1962).

this Court's holding in the *Sullivan* case, with its *dictum* in the *Tank Truck* case. The apparent inconsistency between the holding in the one case, and the opinion in the other, has led to a predictable continuation of the conflict in policy-frustration decisions by the Courts charged with administering federal tax law on a basis of national uniformity.

On the specific question involved in this case—whether a taxpayer may be denied an otherwise valid tax deduction because he has failed to establish his innocence of a charge of crime against state law in incurring the expense—a distinct conflict of authority has developed between the Courts of Appeals for the Fifth and Tenth Circuits on the one hand, and the Court of Claims and the Tax Court on the other.

The great importance of policy-frustration questions is evidenced by this Court's repeated grants of certiorari in this field over the past 22 years, in an effort, which has not yet achieved fulfillment, to iron out the clashes among the lower federal courts. In 1958, this Court granted certiorari in the *Sullivan* case for the purpose of settling the precise question at issue in the case at bar; but the *Sullivan* decision, because of its peculiar conjunction with the *Tank Truck* opinion, has only exacerbated—not abated—the conflict on this point.[14]

[14] "When three unanimous Supreme Court decisions on controversial and related issues are handed down concurrently, some clarification might be expected. It will not be found here. Juxtaposition of these decisions in the reports only dramatizes the absence of coherent solution. In the *Hoover* and *Tank Truck* decisions, fines were ruled non-deductible

The Internal Revenue Service considered the District Court's decision in the case at bar to be of such significance that, shortly after that decision was rendered, it issued a special Technical Information Release (TIR-397) calling attention to the holding "as an example of a recent application of" the policy-frustration doctrine, and noting the Service's disagreement with the conflicting decision by the Tax Court in *Marlen E. Pew, Jr.*, 30 P-H TC Memo. Dec. 1505. Not long afterward, this special Release was made the subject of a formal Revenue Ruling (*Rev. Rul. 62-194*, 1962-46 IRB 7).

The particular question presented in this, as in the *Sullivan* case, raises serious and fundamental issues as to federal-state government relationships, and as to procedures governing punitive assessments—issues which are peculiar to the denial of a deduction on the ground of an unproved federal charge of state crime, and which go beyond the limits of the policy-frustration doctrine and even of tax law, and approach the gravity of constitutional questions.

The importance of one of these issues—whether a tax deduction may, for punitive and deterrent ends,

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because the statutes which had been violated were taken as expressions of public policy. In the *Sullivan* decision, public policy was ignored, and expenditures in direct violation of state criminal statutes were held deductible. Are fines the controlling distinction? Or are illegal expenses deductible for unlawful business alone? If the truckers had paid prohibited wages, and the bookmakers had been fined for breaking highway regulations, would the decisions have been reversed? Such questions must multiply with successive cases until Congress and the Supreme Court construct some consistent relation between state law enforcement and federal taxation." Note, 5 New York Law Forum 208, 213 (1959).

be conditioned on the taxpayer's exculpation of itself from a charge of crime—is given special emphasis by the unseemly disparity in result between this case and the other cases in the same line which allowed deductions of the same payments because the taxpayers were held in those cases successfully to have discharged this burden of proof.

It is respectfully submitted that these important conflicts and issues urgently call for resolution by this Court at this time; and that certiorari should accordingly be granted.

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Opinion of the Court of Appeals

Before RIVES, Circuit Judge, and BOOTLE and WEST, District Judges.

BOOTLE, District Judge: Is it the province of the Internal Revenue Service to set itself up as a censor of business ethics? Were that, thus broadly stated, the question for decision, much of appellant's argument, by brief and orally, would be unanswerable. That argument supported by numerous decisions and law review articles proceeds something like this: "Moral turpitude is not a touchstone of taxability."[1] The disallowance of deductions upon considerations of public policy suggest criteria too vague and amorphous for acceptance. "Tax laws should give plain notice of their commands. A statute which either forbids or requires the doing of an act 'in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application' violates 'the first essential of due process of law.'"[2]

The object of the income tax bill of 1913 was "to tax a man's net income, that is to say, what he has at the end of the year, after deducting from his receipts his expenditures or losses. It is not to reform men's moral character; that is not the object of the bill at all."[3] "[M]oral turpitude is a very poor

[1] *Commissioner of Internal Revenue v. Wilcox*, 327 U. S. 404, 408, 90 L. Ed. 752, 755 (1946)

[2] Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, 1954 Major Tax Problems, (Southern California Tax Institute) 715, 741.

[3] 50 Cong. Rec. 3849. (Remarks of Senator Williams)

criterion for taxability and . . . in the interests of good tax administration, Uncle Sam shall take his taxpayers as he finds them, exact his normal share of their net income, and let someone specifically charged with the job punish them for their sins. If the tax collector is required to sit in judgment on the morals of his clients, he will be doing something for which he has neither the training nor the knowledge and he will be adding to his already heavy administrative burdens. Furthermore, uneven and discriminatory application of the tax laws will result. There are too many different types and degrees of wickedness, and there are too many different attitudes toward sin on the part of tax officials and judges."[4] The Internal Revenue Code should not be used as a "mandate for extirpating evil"; espousal of the public-policy concept would result in a tax on gross rather than net income, and thus be "inconsistent with a code geared to the latter concept"; the public policy which declares a payment illegal also prescribes stated penalties therefor, and it would be inconsistent with the policy of the statute to add another penalty—loss of a tax deduction—not contemplated thereby; the tax penalty resulting from disallowance of claimed deductions might be absurdly disproportionate both to the nature of the offense and to the penalty therefor prescribed by statute; attempted enforcement by federal tax authorities of the policy of state statutes would have far reaching effects, of dubious advantage, on the distribution of law enforcement powers between the fed-

[4] Reid, *Disallowance of Tax Deductions on Grounds of Public Policy, A Critique*, 17 Fed. B.J., 575, 578.

eral and state governments; and the state statutes or regulations relied upon as expressive of state policy may be but dead-letter proscriptions, "nominal, not effective law", and not expressive of current community sentiment at all.[5] And not overlooked is the comment of Mr. Justice Burrough in England nearly a century and a half ago: "I, for one, protest, as my Lord has done, against arguing too strongly upon public policy;—it is a very unruly horse, and when once you get astride it you never know where it will carry you. It may lead you from the sound law. It is never argued at all but when other points fail."[6]

Some of appellant's arguments have been thus lengthily summarized to demonstrate the forcefulness they would have, how unanswerable they would be, were the question here as broad as that above stated. Unfortunately for appellant, however, the precise question in this case is much narrower. Appellee nowise claims such carte blanche for the Internal Revenue Service.

The question for decision is whether certain payments made by appellant, a ship-repair yard of New Orleans, to officers of foreign ships are deductible as ordinary and necessary business expenses under §23(a) (1) (A) of the 1939 Code;[7] or nondeductible

[5] Comment, *Business Expenses: Disallowance, and Public Policy*, 72 Yale L. J. 108 (1962)

[6] *Richardson v. Mellish*, 2 Bing. 229, 252, 130 E R 294, 303 (C P - 1824)

[7] Internal Revenue Code of 1939:

"Sec. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] Expenses.

because violative of Louisiana's Commercial Bribery Statute[8] and of Louisiana's public policy as defined and expressed by said statute and by the decisions of its highest courts?

As a reading of the Commercial Bribery Statute discloses, a subsidiary and threshold factual question is whether the payments were made "without the knowledge and consent" of the employers of the payees, that is to say, the owners of the foreign ships?

This subsidiary question demands priority of treatment. The Government's contention is that the payments are nondeductible because to allow such deduction would frustrate the sharply defined public policy

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"(1) Trade or business expenses. -

"(A) In general. - All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *"

26 U.S.C. § 23 (1952)

[8] La. Rev. Stat., Title 14 (1950)

Sec. 73. Commercial bribery.

"Commercial bribery is the giving or offering to give, directly or indirectly, anything of apparent present or prospective value to any private agent, employee, or fiduciary, without the knowledge and consent of the principal or employer, with the intent to influence such agent's, employee's, or fiduciary's action in relation to the principal's or employer's affairs.

"The agent's, employee's or fiduciary's acceptance of or offer to accept, directly or indirectly, any thing of apparent present or prospective value under such circumstances shall also constitute commercial bribery.

"The offender under this article who states the facts, under oath, to the district attorney charged with prosecution of the offense, and who gives evidence tending to convict any other offender under this article, may, in the discretion of the district attorney, be granted full immunity from prosecution for commercial bribery, in respect to the particular offense reported.

"Whoever commits the crime of commercial bribery shall be fined not more than five hundred dollars, or imprisoned for not more than one year, or both."

of the State of Louisiana. For the Government to prevail on this contention it is necessary that the payments be made in violation of the Commercial Bribery Statute including the element of being "without the knowledge and consent" of the ship owners. Unfortunately for appellant, that issue has been found as a fact against it by the District Court before whom by stipulation all issues were tried without a jury.

Before adverting further to the action of the trial court the nature and circumstances of the payments should be related. The facts, as summarized in appellee's brief, are as follows:

> "Taxpayer is a corporation engaged in the ship-repair business in New Orleans, Louisiana. During its fiscal years ended June 30, 1951, and June 30, 1952 repairs on foreign ships accounted for a substantial part of taxpayer's total business.
>
> "Generally, repair work to be done on foreign ships is let out by the ship's captain and chief engineer who have the sole prerogative of selecting the ship-repair yard. During the years in question, foreign ships, upon arrival in the Port of New Orleans, were met by representatives of the taxpayer who attempted to solicit the repair business. It was generally known that taxpayer was willing to pay the officers of foreign ships a percentage of the repair bill in order to obtain the business. According to taxpayer, the captain and chief engineer expect these payments, and if not given, taxpayer would not get the business or

the cooperation of the crew during the performance of the repairs. It was, therefore, taxpayer's practice to kickback approximately 10% of the repair bill to the captain and chief engineer of all foreign-owned ships repaired by it. Similar payments were not made to officers of American ships because repair work on these ships is let out by American agents rather than by the captain and chief engineer.

"The repair jobs on foreign ships were performed on a time and material basis. After the bill for actual man-hours and materials had been computed, an amount of 14 to 15% was added to it to cover the 10% kickback to the ship officers plus 4 to 5% for withholding tax purposes. This additional amount was not specifically ear-marked, but was included in the bill by increasing the number of man-hours spent on the job.

"Upon completion of the repairs, taxpayer's representative carried the invoice to the ship for approval by the chief engineer and the captain. Usually the invoice was taken to the chief engineer first who signed it to indicate that the repairs had been satisfactorily performed. Having obtained his signature, the representative would give the chief engineer a sealed envelope containing approximately 5% of the repair bill in cash. The invoice was then taken to the captain, who after signing it, also received 5% of the repair bill in cash. No receipts were obtained. The invoice, being approved for payment, was then sent either

directly to the owners or to their agents in the United States.

"Kickbacks totalling $41,940.01 and $79,311.43, for the fiscal years 1951 and 1952 respectively, were claimed as deductions by taxpayer in its income tax returns for those years. The District Director disallowed the deductions on the grounds that the payments, made without the knowledge and consent of the ship-owners, violated the Louisiana Commercial Bribery Statute, . . . and were therefore not deductible as ordinary and necessary business expenses. Taxpayer was assessed additional taxes in the amount of $24,796.22 for 1951 and $63,191.49 for 1952, together with interest in the amount of $22,980.88.

"Taxpayer paid the additional assessment . . . and instituted the present suit for refund. . . ."

Additionally, appellant contends that the payments were made in accordance with a long-standing universal[9] custom among ship-repair companies; they were made for two reasons: (1) any repair yard which did not make them would get no work on foreign-flag vessels, and (2) they were made in consideration of assistance, rendered by the vessels' officers and crews, whose cooperation in various ways is essential to quick and efficient repair work, particularly since these repairs are generally made while the crew is at work loading or unloading; that these are the only

[9] Upon oral argument counsel for appellant stated that the custom was so close to universal as to amount to the same thing.

reasons motivating the payments, and that they are not bribes to buy approval of bad work. Appellant emphasizes also that it, during the entirety of its business career of nearly half a century, has made similar payments to officers and members of crews of foreign vessels, has entered them openly on its books, and has always—beginning long before the controversy in suit—made full reports thereof, and remitted all taxes withheld therefrom, to the Government, which has, except as to the years here involved—both before and since—always allowed deduction thereof.

The case was submitted for decision by the court below on the record consisting of pleadings, affidavits, depositions, and exhibits, no witnesses being heard in open court. In its effort to prove the alleged universal custom and that the ship owners with whom we are here concerned knew about it, taxpayer used many affidavits and depositions. The Government also used many affidavits. Taxpayer used, among others, depositions of four steamship agents, one ship repairer, and three former foreign ship officers, two of whom were subsequently employees of taxpayer; and numerous affidavits of foreign ship owners and operators, of whom four were from Italy, four from the Netherlands, three from Denmark, two from Norway, one from Brazil, one from Germany, one a former master of Yugoslav and Panamanian vessels, and one identified as a foreign ship captain. All these deponents and affiants testified generally in support of the existence of the custom and that it was usual and customary to make these payments and that they

were not objectionable from the ship owners' point of view because they facilitated and accelerated the repairs. Many of these witnesses testified that in their opinion it was generally known to ship owners that these payments were customarily made, and that it was particularly known to those owners who were formerly ship masters. The Government sharply disputed taxpayer's contentions that the practice was universal, that it was well known in shipping circles, and that it was known to ship owners in general or to the owners of ships repaired by taxpayer during the years in question in particular. The trial court pointed out that to contradict taxpayer's contentions the Government produced a number of affidavits of foreign ship owners "all of whom had repairs made by taxpayer during the fiscal years involved", including three from Norway, four from the Netherlands, seven from Italy, two from France, and three from Germany. Thus while many of the Government's affiants were owners of ships which had been repaired by taxpayer during the years in question, none of taxpayer's affiants or deponents indicated whether the firm they represented had any ships repaired by taxpayer. Taxpayer's evidence was not aimed specifically at proving that the foreign owners of ships repaired by it during the years involved actually knew of, or consented to, the payments it made to the officers of their ships. It was aimed rather at proving the existence of a long standing universal custom that such payments be made and that ship owners had knowledge of this custom in general but not in its specific application to them. On the other hand, the Government's affiants swore

that although their ships had been repaired by taxpayer during the years in question they had no knowledge that taxpayer had made payments to the officers of their ships, or that their bills had been padded, and that they would not have consented to it. They generally were not aware of any such long-time or so-called universal custom and had no knowledge of taxpayer's practice in this regard; one who had heard of "isolated incidents" looked upon such practices as "thoroughly unethical"; another said such "goings-on" were "strongly forbidden by all the companies I know"; another said his company requires its captains to sign a pledge that they will not accept kickbacks; another said his company has a regulation which expressly forbids employees from accepting kickbacks with the threat that "severe action" will be taken if the regulation is violated; another said his company has offered to pay to captains a bonus equal to twice the amount of any kickback remitted to the company; and another said "in my opinion no German shipping firm would authorize such dishonest practices. From my experience I wish to state that all other shipping firms in Northern Europe are of the same opinion."

Upon the evidence the trial court found as a fact: "It cannot be said that plaintiff has clearly established by a preponderance of the evidence that the practice is universal or known to the owners of the ships repaired by it; there is ample evidence to the contrary. . . . The evidence shows to our satisfaction that foreign ship owners actually doing business with taxpayer were not aware of the 10% kickback nor of

the padding of their bills by taxpayer in order to achieve this result."

As it must, taxpayer attacks this finding head on, its first specification of error being that the District Court clearly erred in finding that the evidence fails to establish knowledge of the payments on the part of the ship owners. We do not agree. Taxpayer's sole reliance for proof of knowledge was upon the alleged custom and its claimed universality. We think the evidence amply sustained the finding that the custom was not universal, was not known to the owners of the ships repaired, and that said ship owners were not aware of the kickbacks nor of the padding of their bills.

Taxpayer contends next that under the Louisiana statute defining a crime as the making of a payment "without the knowledge and consent" of the employer, the crime is committed only if the payment is made "without the knowledge and without the consent" of the employer, citing Fowler, A Dictionary of Modern English Usage 408 (under O R 4) (1937). Here again we cannot agree. We think this would be a strained construction. We think the legislature of Louisiana intended to outlaw such payments unless they were accompanied by both the knowledge and the consent of the employer. Moreover, in this case the evidence fails to show consent just as it fails to show knowledge. Indeed, it would be difficult to show consent without showing knowledge, and where, as here, the sole reliance for proof of both knowledge and consent is

an alleged universal custom known to the owners, and the proof fails to establish that the custom is universal or that it is known to the owners, then proof of knowledge fails and proof of consent also fails.

No contention has been advanced that the payments were not made "to influence such agent's, employee's, or fiduciary's action in relation to the principal's or employer's affairs." The record is replete with evidence that if taxpayer made no payments it would get no work. The trial court's finding is dispositive of this facet of the case: "The transaction is clearly prohibited by the Louisiana Commercial Bribery Statute and we cannot give our sanction to it."

With the facts thus established we come to the final and broader question embraced in taxpayer's sole remaining specification of error: Regardless of knowledge of the payments by the ship owners, the District Court erred as a matter of law, in holding that the payments are non-deductible. This is another way of contending that regardless of the fact that the payments are clearly violative of the Louisiana Commercial Bribery Statute and of Louisiana's public policy as defined and expressed by said statute and by the decisions of its highest courts, said payments are nonetheless deductible as ordinary and necessary business expenses.

The Supreme Court has given thought to this question. "But the problem is not solved when the payments are characterized as necessary. . . . There

is need to determine whether they are both necessary and ordinary." *Welch v. Helvering*, 290 U. S. 111, 113, 78 L. Ed. 212, 214 (1933). Then too, "allowance of deductions from gross income does not turn on general equitable considerations. It 'depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.'" *Deputy v. du Pont*, 308 U. S. 488, 493, 84 L. Ed. 416, 421 (1939). Moreover, allowance or disallowance depends upon the "special facts" of each case. *Deputy v. du Pont*, *supra*, at page 496. This is true also and perhaps particularly in cases akin to the one at bar involving claimed tax deductions, the allowance of which would have consequences which would "frustrate sharply defined national or state policies proscribing particular types of conduct." *Commissioner v. Heininger*, 320 U. S. 467, 473, 88 L. Ed. 171, 176 (1943). In considering the special facts of each case, "there are norms of conduct that help to stabilize our judgment, and make it certain and objective", suggesting the inquiry whether the instance is "erratic", or "brought within a known type." *Welch v. Helvering*, *supra*, at page 114. In *Textile Mills Sec. Corp. v. Comr. of Int. Rev.*, 314 U. S. 326, 86 L. Ed. 249 (1941), the Court, in holding nondeductible lobbying expenses which ran afoul of a Treasury Regulation held that the Internal Revenue Service had not usurped the legislative function in carving out this special group of expenses and making them nondeductible; that the words "ordinary and necessary" are not so clear and unambiguous in their meaning and application as to leave no room for an

interpretative regulation, and that there was justification for "drawing a line between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." At page 339. Shortly thereafter, in *Commissioner v. Heininger, supra*, the Court came closer to our problem and, while allowing deduction of attorneys' fees and related legal expenses incurred in unsuccessfully attempting to obtain an injunction against a fraud order issued by the Postmaster General affecting taxpayer's business, ruled as follows:

> "The Bureau of Internal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in § 23(a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct. A review of the situations which have been held to belong in this category would serve no useful purpose for each case should depend upon its peculiar circumstances. A few examples will suffice to illustrate the principle involved. Where a taxpayer has violated a federal or a state statute and incurred a fine or penalty he has not been permitted a tax deduction for its payment. Similarly, one who has incurred expenses for certain types of lobbying and political pressure activities with a view to influencing federal legislation has been denied a deduction. And a taxpayer who has made payments to an influential party precinct captain in order to ob-

tain a state printing contract has not been allowed to deduct their amount from gross income." At pp. 473, 474, 88 L. Ed. 176.

The Court then went further and said that "if the respondent's litigation expenses are to be denied deduction, it must be because allowance of the deduction would frustrate the sharply defined policies of 39 U.S.C.A. §§ 259 and 732 . . . which authorize the Postmaster General to issue fraud orders", and then commented that allowance of deductibility would not result in frustration of those policies, those policies being simply to protect the public from fraudulent practices committed through the use of the mails and not to deter persons accused of violating their terms from employing counsel to assist in presenting a bona fide defense. And coming even closer to our question, the Court, in *Lilly v. Commissioner of Int. Rev.*, 353 U. S. 90, 96 L. Ed. 769, while allowing deduction of payments made by opticians to physicians of 1/3 of sales price of glasses sold to their patients did so upon the ground that at the time and place in question the payments under consideration did "not fall in that class" of expenses which would "frustrate sharply defined national or state policies proscribing particular types of conduct", saying that "the policies frustrated must be national or state polices evidenced by some governmental declaration of them. In 1943 and 1944 there were no such declared public policies proscribing the payments which were made by petitioners to the doctors." At pp. 96, 97. The Court said further, "we do not have before us the issue that would be presented

by expenditures which themselves violated a federal or state law or were incidental to such violations. In such a case it could be argued that the outlawed expenditures, by virtue of their illegality, were not 'ordinary and necessary' business expenses within the meaning of § 23(a) (1) (A)." At p. 94. *Lilly* indicates right plainly that with the enactment of laws by North Carolina outlawing the practice the deduction would no longer be allowable, saying, "we recognize the province of legislatures to translate progressive standards of professional conduct into law and we note that legislation has been passed in recent years in North Carolina and other states outlawing the practice here considered. . . . A resulting abolition of the practice will reflect itself in the tax returns of the parties without the retroactive hardship complained of here." At pp. 97, 98. And coming even closer to our case, and as if to lay the matter at rest, the Court, in *Tank Truck Rentals v. Commissioner*, 356 U. S. 30, 2 L. Ed. 2d. 562 (1958), in disallowing deduction of fines imposed upon drivers of a trucking corporation for violations of a state statute prescribing maximum truck weights said, "a finding of 'necessity' cannot be made, however, if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof" and continued "although each case must turn on its own facts . . . the test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction. The flexibility of such a standard

is necessary if we are to accommodate both the congressional intent to tax only net income, and the presumption against congressional intent to encourage violation of declared public policy.

"Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. . . . If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, as in the present case, the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance. Deduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature." At pp. 33, 6, 2 L. Ed. 2d 566, 567. Under the *Tank Truck* holding it seems obvious that since a penalty payment although not directly prohibited by statute is nondeductible under the frustration rule because its attendant frustration is "only slightly less remote" than that to be expected from allowance of an expense which "is itself prohibited by statute", then a fortiori the outlawed expenditure itself must be disallowed because "certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute."[10]

[10] The following reasons have been suggested for the limited number of direct holdings of nondeductibility of commercial bribery payments, and other illegal expenditures:

"Commercial Bribery and Similar Payments. — The number of cases presenting the issue of commercial bribery has been indirectly limited by the Commissioner's policy that be-

Taxpayer's reliance upon the "ship chandler" cases, *Richardson v. Commissioner*, decided June 28, 1957, 26 P-H Tax Ct. Mem. 439, 16 CCH Tax Ct. Mem. 518 (1957), *rev'd. in part*, 264 F. 2d 400 (4th Cir. 1959); *Fiambolis v. United States*, 152 F. Supp. 10 (E.D. S.C. 1957), and *Valetti v. Commissioner*, 28 P-H Tax Ct. Mem. 692 (1957), *aff'd. in part and rev'd. in part*, 260 F. 2d 185 (3d. Cir. 1958), is misplaced. In *Richardson* there was was a finding of fact that the foreign ship owners and their local agents were "aware of this practice"; in *Fiambolis* there was a finding of fact that the owners of the ships "not only knew about the practice of their captains and masters receiving discounts, but actually approved of it"; and in *Valetti* there was a finding of fact that "the owners of the ships knew such commissions were being paid." In the case at bar the fact findings are the other way.

Taxpayer seeks comfort also in *Commissioner v. Sullivan*, 356 U. S. 27, 2 L. Ed. 2d. 559 (1958). We should hardly expect to find irreconcilability between *Sullivan* on the one hand, and *Tank Truck Rentals* and its com-

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fore a taxpayer may deduct payments for personal services he must furnish the Commissioner with the name, address and amount paid to each recipient. But where the question has been presented, the courts have usually justified the disallowance on the ground that such expenditures are not 'ordinary', or that, in any event, they are not 'necessary'." Note, *Deductions of Business Expenses: Illegality and Public Policy*, 54 Harv. L. Rev. 852, 857 (1941).

"Where the expenditure itself is in violation of a statute, it would presumably be a rare case in which a court would be willing to call the expenditure 'ordinary and necessary' in itself, so that a choice between the conflicting policies of allowing deduction for ordinary and necessary expense but disallowing deduction for expenses 'contrary to public policy' would hardly arise." Surrey and Warren, Federal Income Taxation, Cases and Materials, 243 (1960).

panion case, *Hoover Motor Express Co. v. United States*, 356 U. S. 38, 2 L. Ed. 2d. 568 (1958), on the other. These three are companion cases considered and decided together on the same day, each by the same unanimous Court. No conflict was discerned there. In *Sullivan* the issue was the deductibility of rent and wages paid in the operation of an illegal gambling enterprise. The Tax Court had considered the problem in three cases arising under the statutes of Illinois. The statutes relied upon by the Commissioner in these cases are Illinois Revised Statutes, Ch. 38 (Criminal Code), §§ 139, 140, 336, and 582. Sections 139 and 140 are general conspiracy statutes. Section 336 makes the conduct of a bookmaking establishment illegal and provides also that any person who records or registers wagers shall be punishable. Section 582 is a general aiding and abetting statute. In *Commissioner v. Doyle*, 23 P-H Tax Ct. Mem. 1067 (1954), aff'd., 231 F. 2d 635 (7th Cir. 1956), the Commissioner contended that amounts paid for wages and rent in the conduct of such establishments were nondeductible as they "would frustrate the laws of Illinois which prohibit bookmaking". The Tax Court decided in favor of deductibility. The Court of Appeals for the Seventh Circuit in affirming the Tax Court's decision held that whether the expenditures be "lawful or unlawful" they were deductible because they were "an integral part of a business," adding "integrality is the test." In *Mesi v. Commissioner*, 25 T. C. 513 (1955), *rev'd.* 242 F. 2d 558 (7th Cir. 1957), *aff'd.* 356 U. S. 27, 2 L. Ed. 2d. 559 (1958), the Tax Court held that wages paid by one who conducted an illegal bookmaking busi-

ness were non-deductible saying that under §§336 and 582 "the payment of the wages in question in and of itself constituted an illegal act. The wages paid by petitioner were paid to procure the direct aid of others in the perpetration of an illegal act, namely, the operation of a bookmaking establishment." In *Ross v. Commissioner* and *Sullivan v. Commissioner*, P-H 25 T. C. Mem. 19 (1956), *rev'd.* 241 F. 2d 46 (7th Cir. 1957), *aff'd.* 356 U. S. 27, 2 L. Ed. 2d. 599 (1958), the Tax Court extended its wages ruling in *Mesi* to wages and rent saying "we think that the principles there [in *Mesi*] announced are equally applicable to rental payments on the facts presented in the instant case. It is clear that the lessor as well as the lessees was fully aware that an illegal bookmaking enterprise was being carried on upon the premises, and that both the payment and receipt of rentals were in violation of sections 336 and 582 of the Illinois Revised Statutes." At pp. 23, 24. The decisions of the Tax Court in *Mesi*, *Ross*, and *Sullivan* were reversed by the Court of Appeals for the Seventh Circuit under the integrality test of *Doyle*. When *Sullivan*, *Ross*, and *Mesi* reached the Supreme Court Mr. Justice Douglas for the Court pointed to the Federal Government's recognition of gambling as a business enterprise for Federal tax purposes and to the regulations[11] which make the Federal excise tax on wagers deductible as an ordinary and necessary business expense, concluding that "the policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to al-

[11] Treas. Reg. 118, § 39.23(a)-1, Rev. Rul. 54-219, 1954-1 Cum. Bull. 51.

low the normal deductions of the rent and wages necessary to operate it." At p. 29. If in Illinois a gambler's payment of wages and rent constitutes a criminal act it is so because of the general provisions of § 336 making the conduct of a bookmaking establishment illegal or because of the general provisions of the aiding and abetting statute. There is no specific statute or language making it a crime for a gambler to pay his wages or his rent. There is not in that area therefore the same specificity of proscription which marks the Louisiana statute's treatment of commercial bribery. The state policy in the one instance is not as "sharply defined" as in the other.[12] One writer has said that *Sullivan* simply holds that expenses which are clearly deductible by a legitimate business are also deductible by an illegitimate business.[13]

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[12] In addition to the pointedness of the statute the court below discerned other expressions of this policy in the jurisprudence of Louisiana, observing: "Padding the repair bill to take care of the amount of the payments, and thereby to make the ship owner himself pay for the kickback, without his knowledge or consent, is a species of fraud also forbidden by Louisiana Criminal Statute. See La. R. S. Title 14:67.", and that "the Louisiana judicial decisions likewise indicate the illegal nature of the transactions involved here and the impropriety of the crew accepting gratuities without the specific knowledge or consent of their principals, the ship owners." Citing *Foreman v. Pelican Stores*, 21 So. 2d. 64 (Ct. App. La. 1944).

[13] Roehner on Federal Taxation, Vol. 8, Number 5, January 11, 1963:

"When the Supreme Court decided *Sullivan*, *Tank Truck Rentals*, and *Hoover Motor Express Co.*, all in 356 U. S. (1958), we found no conflict between *Sullivan* and the two others.

"In *Sullivan*, the Court held that payments for salaries and rent were deductible by a bookmaker, although against State law. In the other two cases, the Court held that fines paid by trucking companies to the State for weight violations were not deductible.

"To us the Court was clearly correct in all three cases. Before the Court decided Sullivan, we had taken the position

The decisions of this court in *Alexandria Gravel Co. v. Commissioner of Internal Revenue*, 95 F. 2d. 615 (1938), and *Commissioner of Internal Revenue v. Longhorn Portland Cement Co.*, 148 F. 2d. 276 (1945), tend strongly to foreshadow our present holding.

The judgment of the trial court was right, and is

AFFIRMED.

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that expenses that were deductible by a legitimate business were deductible by an illegitimate business, which is all that *Sullivan* held. In the other two cases the fines were not deductible by any business."

Opinion of the District Court

AINSWORTH, District Judge:

This is a taxpayer's suit for refund of income taxes paid for fiscal years 1951 and 1952. By agreement of the parties it is being decided on its merits on the record consisting of pleadings, affidavits, depositions and exhibits described in a joint stipulation.[1] The question presented is whether certain payments made to officers and members of crews of foreign vessels by a ship-repair yard to obtain the business and expedite the repairs are deductible as ordinary and necessary business expenses under Section 23(a)(1) of the Internal Revenue Code of 1939.[2] If the payments are deductible, the taxpayer is entitled to refund. We hold that such payments are not deductible, being in violation of sharply defined public policy which proscribes this type of conduct.

Taxpayer contends that there exists in the Port of New Orleans, as in all other ports, a long-standing custom among ship-repair companies to pay to officers and members of crews of foreign vessels under repair, for so-called services rendered, approximately 10% net (after deduction of withholding taxes) of the cost of the repair work. It states that if it did not make the payments it would get no work from foreign vessels; that

[1] See stipulation dated November 21, 1961.

[2] Internal Revenue Code of 1939:

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"(a) [As amended by Sec. 121(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

"(1) *Trade or business expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *"

the payments are in consideration of assistance rendered by the vessels' officers and crew and that cooperation of the ships' personnel is essential to quick and efficient repair work. Therefore, the assistance is valuable, it is said, both to the shipowner and the repair yard. Taxpayer states that the payments are not bribes to buy approval of bad work but that they are customary among all persons who do business with foreign ships. It is stated that the practice is one of common knowledge in shipping circles and that all vessel owners are familiar with it.

The testimony of the president of taxpayer corporation is offered to support these statements,[3] as are those of other persons stated to be familiar with these practices,[4] to the effect that a net amount of approximately 10% of the amount of the repair bill, or 5% to each, is usually paid in cash to the captain and chief engineer. Numerous affidavits of foreign shipowners and operators are also offered in support of the existence of the custom, that it is usual to make these payments which are said to be unobjectionable from the shipowner's point of view because they facilitate and accelerate the repairs.[5] Taxpayer's president testified that repair jobs

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[3] See deposition, Exhibit P-11.

[4] The depositions are made by four steamship agents, Abaunza (Exhibit P-4), Barr (Exhibit P-5), Gordon (Exhibit P-8) and Whitcomb (Exhibit P-12); one ship repairer, Binnings (Exhibit P-6); and three former foreign ship officers, Fredotovich (Exhibit P-7), Rusovich (Exhibit P-9) and Svendsen (Exhibit P-10), the latter two of whom were subsequently employees of taxpayer.

[5] See affidavits of taxpayer's affiants, P-14 through P-29, inclusive; and P-32, of whom four were from Italy, four from The Netherlands, three from Denmark, two from Norway, one from Brazil, one from Germany, one was a former master of Yugoslav and Panamian vessels, and one was identified as a foreign ship captain (Schultz, Exhibit P-28).

are done in its shipyard on a so-called time and material basis. After the bill for actual man-hours and materials is computed, an amount of 14 to 15% is added to it, and the bill is thus padded by recomputing the number of man-hours necessary for a total which amounts to the actual charges plus 14 to 15%.[6] In some instances, the services of members of the crew are also employed in making repairs and the number of hours a shipowner's crew works is also added to the bill as if they were employees of taxpayer.[7] When foreign ships arrive in the Port of New Orleans, they are met by representatives of taxpayer who attempt to obtain repair business. It is generally known that taxpayer is willing to give the officers of the ship "a new hat"[8] and, accordingly, tax-

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[6] See testimony of taxpayer's president, Szodomka (Exhibit P-11, p. 24), as follows:

"Q When you make these payments and I understand that every contract that you get you expect to make a payment that amounts from 5 to 10% to the master or captain or the crew when you enter into the contract you figure that in as part of the cost of your work, don't you?

"A Yes, sir.

"Q *And that is added to the price?*

"A *That is added to the price.* That was added to it before he signed the bill.

"Q I don't know if you understood me right. You figured on adding that to the total of the amount which you charged?

"A The best way that I can explain that, is I have some on the job and don't show it on the payments. *We add so many man-hours to the job.*

"Q And then you figure what you are going to pay back and that is added to the cost of the contract?

"A Man-hours on the job.

"Q. And that is what you expect to get in toto from the ship owners for your work?

"A Yes." (Emphasis added.)

[7] Szodomka (Exhibit P-11, p. 20), as follows:

". . . In other words, they help us so much as they can *and we charge the full time for these men, like we charge anybody else.* We give him a little more. That don't happen very often." (Emphasis added.)

[8] Aesopian for kickback.

payer receives a large portion of the business sufficiently substantial that in fiscal 1951 it amounted to 19% of its total business, and in 1952 36% of its total business.[9] It is said that the captain and chief engineer expect these payments and if they are not given taxpayer would not get the work nor would it obtain the cooperation of the crew during the performance of the repairs. It is, therefore, the practice of taxpayer to make such payments to the captain and chief engineer of all foreign-owned ships. American ships' personnel do not exact such payments and these ships are usually represented by American agents who have authority themselves to secure repairs. On the other hand, repairs of foreign vessels are secured entirely by the captain and chief engineer who have the sole prerogative of selecting the ship-repair yard.

Taxpayer, therefore, contends that the making of such payments is a practice which is universal, of long standing, well known in shipping circles and is known to the owners of the vessels. The Government sharply disputes this and, to contradict taxpayer's contention, produced a number of affidavits of foreign shipowners, all of whom had repairs made by taxpayer during the fiscal years involved.[10] In every instance the shipowners disclaimed any knowledge of the payments, said they were unaware that their bills for repairs had been padded, disputed the right of their captain and chief engineer

[9] Szodomka (Exhibit P-11, p. 38).

[10] See affidavits of the Government's affiants, G-2 through G-21, inclusive, of whom one was from the United States (George Elias, Jr., Tax Division, Department of Justice), three from Norway, four from The Netherlands, seven from Italy, two from France, and three from Germany. (Exhibit G-20 is joint affidavit by two German citizens.)

to take such gratuities and condemned the practice generally. Some of the Government affiants said they were unaware of any such practice though they had heard hints about it on occasions. They absolutely condemned the practice as being opposed to the interests of their companies and said they would severely discipline and might even discharge employees who were caught in such transaction; other Government affidavits showed that some foreign owners doing business with taxpayer were aware that some of their officers and members of the crew were taking gratuities but they were fighting against the practice, severely condemned it and said they were particularly unaware that it had been done by taxpayer when repairs were made to their ships in New Orleans.

It cannot be said that plaintiff has clearly established by a preponderance of the evidence that the practice is universal or known to the owners of the ships repaired by it; there is ample evidence to the contrary. Affidavits of taxpayer's witnesses do not indicate whether the firms represented by the witnesses had ships which were repaired by taxpayer; on the other hand, the affidavits of the Government witnesses specifically stated that they are by persons who used the repair services of taxpayer at New Orleans. The Government evidence is, therefore, specific in its contradiction and denial of the so-called universal custom of paying kickbacks[11] of an average of 10% to the captain and chief engineer

[11] "Kickback" is defined in Webster's Third New International Dictionary (unabridged) as: ". . . a percentage payment exacted as a condition for granting assistance by one in a position to open up or control a source of income or gain . . . ."

where repairs are made to foreign vessels.[12] If these payments or kickbacks are to be allowed and deductible as ordinary and necessary business expenses, they must not frustrate sharply defined state or national public policy.[13]

In *Lilly v. Commissioner of Internal Revenue*, 343 U.S. 90, 72 S.Ct. 497 (1952), the United States Supreme Court permitted as deductible business expenses payments made by optical companies to physicians who referred their patients for the filling of prescriptions for eyeglasses. The *Heininger* rule was nevertheless cited with approval but on the facts the court held that there were no sharply defined state or national policies frustrated thereby.[14]

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[12] The withholding tax due the United States is retained by taxpayer—it amounts to 4 to 5%.

[13] See *Commissioner of Internal Rev. v. Heininger*, 320 U.S. 467, 473, 64 S.Ct. 249 (1943): "The Bureau of Internal Revenue, the Board of Tax Appeals, and the federal courts have from time to time, however, narrowed the generally accepted meaning of the language used in Section 23(a) in order that tax deduction consequences might not frustrate sharply defined national or state policies proscribing particular types of conduct. . . ."

See also *Tank Truck Rentals v. Commissioner of Internal Rev.*, 356 U.S. 30, 78 S.Ct. 507 (1958), in which the court held not deductible fines imposed on truckers who violated state maximum weight statutes, and said, "Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. . . . If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, as in the present case, the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance."

See also *Cammarano v. United States*, 358 U.S. 498, 79 S.Ct. 524 (1959).

[14] Taxpayer cites *Fiambolis v. United States*, 152 F.Supp. 10 (E.D.S.C.); *Valetti v. Commissioner*, 28 T.C. 692; *Richardson v. Commissioner*, C.C.H. 16, T.C.M. 518, 264 F.2d 400, involving gratuities made by ship chandlers to officers of

In Louisiana, the situation is different. The practice of making payments of the kind described here is a violation of the Commercial Bribery Statute of that state. La. R.S. of 1950, Title 14, § 73.[15] The evidence shows to our satisfaction that foreign shipowners actually doing business with taxpayer were not aware of the 10% kickback nor of the padding of their bills by taxpayer in order to achieve this result.[16] The acceptance of gratuities by officers of the ships who were acting in a fiduciary capacity as agents for their shipowner principals was done clandestinely and secretly. The payments were made by taxpayer in cash, in envelopes which were handed to the captain and chief engineer at the time written acceptance of the work was obtained, and no information about them was given to the vessel owners. The transaction was under the table; otherwise, crew members would have been paid in a regular, normal fashion by taxpayer's checks. No

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foreign vessels which were held to be deductible. But the evidence showed *without dispute* in these matters that the owners of the ships *knew* that the commissions were being paid by the chandlers. Such is not the case here, for this fact is sharply disputed in the present case and the evidence shows to the contrary.

[15] Louisiana Revised Statutes of 1950, Title 14, § 73:

"Commercial bribery is the giving or offering to give, directly or indirectly, anything of apparent present or prospective value to any private agent, employee, or fiduciary, without the knowledge and consent of the principal or employer, with the intent to influence such agent's, employee's or fiduciary's action in relation to the principal's or employer's affairs.

"The agent's, employee's or fiduciary's acceptance of or offer to accept, directly or indirectly, anything of apparent present or prospective value under such circumstances shall also constitute commercial bribery."

[16] Padding the repair bill to take care of the amount of the payments, and thereby to make the shipowner himself pay for the kickback, without his knowledge or consent, is a species of fraud also forbidden by Louisiana criminal statute. See La. R.S. Title 14:67.

receipts were obtained from the captain or chief engineer for the payments for, as taxpayer's president testified, if you were the captain or chief engineer, would you give a receipt for such a payment?[17] The transaction is clearly prohibited by the Louisiana Commercial Bribery Statute and we cannot give our sanction to it.

The Louisiana judicial decisions likewise indicate the illegal nature of the transactions involved here and the impropriety of the crew accepting gratuities without the specific knowledge or consent of their principals, the shipowners. In *Foreman v. Pelican Stores*, 21 So.2d 64, 69, the Louisiana Court of Appeal (2 Cir., 1944) summarized the applicable provisions of law as follows:

> "It was held in Clement v. South Atlantic S. S. Line, 128 La. 399, 54 So. 920, that: 'An agent must account to his principal for whatever he has received, even unduly, by virtue of his procuration. An agent of a ship broker must restore to his principal all rebates or refunds received by him, in the absence of an express agreement to the contrary. Custom cannot prevail against the provisions of law.'
>
> "To the same effect are: Chinn v. Chinn, 22 La. Ann. 599; Skannal v. Stevenson, 23 La. Ann. 755; Texana Oil & Refining Co. v. Belchic, 150 La. 88, 90 So. 522.
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> "The common law on the subject is not unlike our own. See: Restatement of the Law, Agency,

[17] Szodomka's rhetorical answers (deposition, Exhibit P-11, pp. 30-31) were:

"Do you think if you were a chief engineer you would give a receipt?

"If you were a chief engineer would you give a receipt on it?"

§§ 403 and 407; 2 Am. Juris. 215, § 268; 13 A.L.R. 907.

"The rule as expressed in American Jurisprudence, supra, reflecting the law of other states, reads: 'It is well established that profits made and advantages gained by an agent in the execution of his agency belong to the principal, unless the parties themselves have otherwise agreed. In the absence of any agreement to the contrary between himself and his principal, an agent is not entitled to avail himself of any advantage that his position may give him to profit beyond the agreed compensation for his services. He will not be allowed to speculate for his gain in the subject-matter of the employment. * * *.'"

We are aware that taxpayer is not on trial here for the violation of any criminal statute and that this is a civil proceeding and a claim for an income tax refund. Nor are we concerned here with the ethics or morals of the practice. But taxpayer is not entitled as a matter of right to a deduction for business expenses and where payments such as these sharply contravene state law by being in specific violation of prohibitory statutes and are also contrary to state policy as defined by the decisions of its highest courts, they cannot be permitted as ordinary and necessary business expenses under provisions of the Internal Revenue Code.

Accordingly, judgment will be entered dismissing plaintiff's suit.

Judgment of the Court of Appeals

This cause came on to be heard on the transcript of the record from the United States District Court for the Eastern District of Louisiana, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be, and the same is hereby, affirmed.

March 21, 1963

Summary of the Evidence on Shipowner Knowledge and Consent

The case was tried, by stipulation, on a record consisting of depositions and affidavits. R 598. The District Judge did not see or hear any of the witnesses. The Government's evidence was submitted entirely in affidavit form. Some of petitioner's witnesses also testified by affidavit; others testified by deposition, and were cross-examined by counsel for the Government.

Knowledge, by the owners of foreign-flag vessels, of the customary payments made by petitioner to the masters and chief engineers of foreign ships which it repaired, was shown by petitioner in four ways: by the testimony of such owners themselves (R 371, 374, 377, 382, 385, 389, 392, 394, 399-400); by the testimony of officers and agents of such owners (R 55, 144-45, 175-77, 199-200, 259, 278, 373, 381, 388, 396); by the testimony of former officers of foreign ships, and others in a position to know (R 55, 58, 241, 332, 364); and by evidence of official governmental recognition of the custom of making the payments.

The testimony, on this point, of those not themselves owners or officers of corporate owners, is based on actual conversations with owners and their representatives (R 176-77, 200, 364); on the fact that many owners of foreign vessels are themselves former masters or ships' engineers who received the payments as such (R 241, 278, 332, 364); and on the fact that it is common knowledge, in shipping circles, that foreign shipowners are

aware of the practice, and pay their ships' officers accordingly (R 145, 259).*

Steamship agency representatives, including the New Orleans principal agent of Lloyd Brasileiro, a Brazilian steamship company for which petitioner has done repair work, testified to the universality of the custom, and to the fact that all vessel-owners are familiar with it (R 52, 138, 145, 256, 259, 275, 278); two of these agency representatives have themselves seen such payments made (R 141-42, 276).

Veteran shipmasters likewise attested the universal nature of the custom, and knowledge thereof by all owners of foreign vessels. R 55, 58, 196, 199, 232, 241. Both shipmasters and ship's engineers testified to their own receipt of payments pursuant to the custom. R 229, 298, 324.

Deponent Binnings, who is president of E. S. Binnings, Inc. (general agents at the Port of New Orleans, representing only owners of foreign-flag vessels) and is also president of Charles Ferran Machine Shop and Ship Repair, Inc. (a large ship-repair yard in New Orleans),

* In cross-examining some of petitioner's witnesses, the Government sought to emphasize the fact that their testimony as to shipowner knowledge of the custom, was, in some cases, based on general awareness of the matter in shipping circles, rather than on the deponent's personal knowledge of specific instances. But Wigmore recognizes, as an exception to the hearsay rule, that custom may be proven by "common opinion or reputation" [5 *Evidence* (3d ed.) 507, section 1625, see also 7 *Evidence* 84, section 1954: specific instances need not be given]; and that reputation may also serve to evidence the probability of knowledge (2 *Evidence* 83, section 261). Further, as shown below, this evidence was confirmed by the Government's own witnesses.

testified: "I know it is practiced to give to officers of the ships certain amounts of money, usually 10%"; that "I have talked at various times with representatives of the owners from the other side"; and that these representatives "made no secret of their knowledge it was going on". R 165, 177.

Deponent Rusovich, petitioner's vice-president, testified that he personally distributed the payments at issue, and that such payments were made with the knowledge of the foreign shipowners, with many of whom he had come in contact personally. R 357, 359, 360a, 364.

Shipowner knowledge of the customary payments was further attested by affidavits of shipowners, and executive officers of shipowning companies, in Italy (four witnesses), Holland (four witnesses), Denmark (three witnesses) and Norway (two witnesses). Most of these shipowner witnesses testified that foreign shipowners not only are aware of the payments, but have no objection thereto; none of the witnesses voiced any objection to the payments. R 370-400.

The existence of the custom has been recognized by the United States War Shipping Administration (see Food Control Regulation No. 3—1944, and *Eugene Richardson*, 26 P-H TC Memo. Dec. 439, 442 (1957), assessment of fraud penalties rev'd, 264 F2d 400); and by the Internal Revenue Service in rulings sustaining the deductibility of payments by ship chandlers pursuant to the custom (*Rev. Rul. 58-479*, 1958-2 CB 60; Letter Ruling, March 14, 1957, quoted at page 69 below).

In a formal tax ruling by its Board of Internal Revenue, the Government of Norway has also recognized officially that the making of these payments by ship-repair yards is universally customary; that receipts are never given for the payments; and that the payments must be made to obtain repair work. Circular No. 117 (1952), R 611.

The Government filed in evidence the affidavits of 19 foreign shipowners. Of these, three—all from Norway—denied outright the existence of the custom at issue. R 504-11. (As noted above, the Government of Norway has recognized the existence of the custom.)

Four of the Government's affiants, from Holland, admitted knowledge of payments pursuant to the custom, without acknowledging the existence of the custom as such. R 511-35. Nine Government witnesses from Italy and France all averred their knowledge of the "practice" of making the payments. R 536-60. Finally, three Government affiants from Germany denied knowledge of payments by petitioner pursuant to the custom; but none of the three denied knowledge of the custom itself. R 561-67. (The Government approached one German shipowner for an affidavit, but did not take the affidavit when he advised the Government's representative of his knowledge of the custom. R 609-10.)

The Government's affiants all stated that they disapproved of the customary payments, but none of their affidavits recites any corrective or disciplinary action taken in regard thereto. One affiant wrote petitioner a letter with reference to (but not protesting) the pay-

ments (R 514-16); but, despite petitioner's failure to answer the letter, this affiant's company has continued to give petitioner regular repair work on its ships. R 603.

The Government based its case, as to the facts, mainly on (a) the lack of knowledge by its shipowner affiants of any specific payment by petitioner, and (b) the fact that the amounts of the payments made by petitioner were added to the repair bills as additional man-hour repair charges, rather than being listed as commission payments to the master and chief engineer.

Of course no foreign shipowner in Europe has personal knowledge of each payment made by an American repair yard to his ship's officers, since these payments are not reported affirmatively to the shipowners. However, by their knowledge of the custom of making the payments, the foreign shipowners know that the payments are made to their ships' officers every time a ship is repaired.

The fact that the payments are added to the repair bills as additional man-hour charges is immaterial. These payments, like all expenses of petitioner's (or any other) business, are necessarily borne by its customers, since they are its sole source of funds. Whether the ultimate charge of the payments is accomplished by express addition to the bill in additional man-hours, or by tacit inclusion in higher man-hour rates or otherwise, has no bearing on the merits of this case. In *Eugene Richardson*, 26 P-H TC Memo. Dec. 439, 442 (1957), assessment of fraud penalties rev'd, 264 F2d 400, the same payments

by ship chandlers were held to be deductible even though they "never appeared as a separate item on the invoice"; and the Commissioner of Internal Revenue's Letter Ruling of March 14, 1957 (page 69 below) also affirmed shipowner knowledge, and deductibility, of such payments, "even though the amounts of the commissions are not separately listed" on the invoices.

Letter Ruling of March 14, 1957

Paul Richman & Company, Inc.,
213 East Water Street,
Norfolk, Virginia.

Gentlemen:

This is in reply to your letter of October 4, 1956, requesting a ruling concerning the deductibility, for Federal income tax purposes, of commissions paid by you, as a marine supplier, to shipmasters, stewards, chief engineers, or other personnel of "tramp steamers" of foreign country registry, under the circumstances hereinafter described.

The factual data developed on the basis of the statements in your letter, and the supporting documents thereto, indicate that in the conduct of your business as a marine supplier, or ship chandler, in selling goods and services to the aforesaid type of steamers, by a trade custom grown up over at least 100 years, you pay a 5% commission of the gross invoice therefor to one of the above-indicated personnel, but usually to the captain or master; and that such practice prevails in the business of other ship chandlers located in each of the larger coastal ports of the United States, of which group 80 or more of them are members of the National Associated Marine Suppliers, Incorporated, having its headquarters at 1024 Dupont Circle Building, Washington, D.C. The custom is described as prevailing not only in the continental United States but also throughout the world. It is said to have arisen in the early days of sailing vessels when ships would be gone from their home ports for

many months, or even years, without any intervening communications from the owners, and each shipmaster during that period was in complete charge of the business and financial affairs of the ship in all necessary respects.

Upon arrival of a foreign ship in a United States port the master usually arranges for the supplies, and after they are placed aboard, he receives, for his sole benefit, from the ship chandler, the said 5% commission, and then approves the invoice by his signature. Payment is made by the owner's agent in that port, or by the owner himself. The master of a foreign ship performs several duties and services not performed by the masters of American ships. He personally chooses the supplier and arranges for the delivery of the various supplies; and supervises the loading on board ship by providing his own crew members. His help and cooperation minimize the tug time and other costs of the work, often receiving supplies at times and places which would not be acceptable to American ships. He also supervises most of the other business matters, such as payment of his crew, the acceptance and often the booking of cargoes and their loading and unloading. The custom of paying the commission is well known to foreign ship owners, and to the agents of such owners who pay the invoices, even though the amounts of the commissions are not separately listed thereon. Most of the ship owners formerly were shipmasters or chief engineers.

Several statements have been supplied by various ship chandlers of East and West coast cities of the United States in corroboration of your statements of the manner

and extent of the commission payments; that such item is appropriate and helpful in obtaining business, is normal, usual and customary in the industry and in the community; is paid with the knowledge of the ship owners; and that they know from specific contacts with owners that the latter are aware of the custom. Relative thereto, E. Urquidi & Co., Norfolk, Virginia, (Exhibit E) had specific working instructions with Spanish owners as far back as 1949, and furnishes a recent trade letter from Pietro Molinello of Genova, Italy as to his knowledge of and consent to the 5% commissions; Mr. Alec M. Choremi, President, General Standard & Marine Corporation, New York, New York, (Exhibit D) has personally talked with approximately 100 foreign owners; R. S. Stern, Inc., Baltimore, Maryland (Exhibit J), in business since 1870, has received direct communications from owners; Richardson Brothers, Charleston, South Carolina (Exhibit K) has paid the commission in the presence of an owner; C. William Brown, Executive Secretary of the National Associated Marine Suppliers, Inc. (p. 2, Exhibit C) has discussed the subject with ship owners and their agents. A statement from M. N. Broughton, Vice-President of your corporation indicates that he has seen the commissions paid in the presence of the owner's agents in the United States and has been advised by them that the owners want the commissions to be paid, (Exhibit G).

You point out that wages of foreign shipmasters, as compared with American shipmasters, are exceedingly low, being fixed with the knowledge that the amounts thereof will be supplemented by the said commissions; that the amounts of the latter, in proportion to the

regular costs and supplies of operating the ship are negligible; and that the charges therefor, included within each invoice, are assumed without question by the ship owner as being additional compensation expense, when considering that the successful operation of the ship largely is in the hands of the shipmaster. The said commission not only compensates the shipmaster for his extra work in connection with the supplies, but is regarded as part compensation for his general services. Also, that most "tramp steamers" of foreign registry are operated as a separate business enterprise. The actual owners of a particular ship may be, and usually are, many and varied. In isolated instances there may be a single owner, but at least 97% of such ships are owned by as many as a hundred or more individuals, each with a proportionate interest in the ship and its earnings, the equivalent of American stockholders in an American corporation. Frequently, the shipmaster is a part owner, and actually is the "General Manager" of the ship's operation by reason of his duties and responsibilities in transacting all of the vessel's business in foreign ports, inclusive of the approval of all bills binding upon it. The typical "home" office of the vessel is a small rented room at the home port with only one or two employees. Most accounts and records are maintained by the master himself and are kept in his own quarters on board ship. Obtaining consent of the owner or owners to any terms under which the master makes agreements for purchases, or even of locating the owner or owners for approval of a shipmaster's orders within the berth time, without costly delay in sailing, would be practically an impossibility.

The position of this office as to whether the commissions paid under the circumstances herein constitute ordinary and necessary business expenses within the purview of section 162(a) of the Internal Revenue Code of 1954 is contained in the conditions outlined in Revenue Ruling 54-27, C.B. 1954-1, page 44, to which you made reference in your supporting presentation. The basic provisions of that Ruling state that so-called "kickback" payments made by taxpayers, subject to the Federal Trade Commission Act, 38 Stat. 717, as amended, to employees or purchasing agents of their customers or prospective customers are not deductible, for Federal income tax purposes, unless the following conditions are met: The payments (1) must be normal, usual, and customary in the industry and in the community, (2) must be appropriate and helpful in obtaining business, and (3) must be made with the knowledge and consent of the customer or prospective customer.

The factual data developed indicate that the instant commissions are paid in a manner and under such circumstances as not to be illegal through the violation of any statutory law; they relate to transactions not in interstate or foreign commerce, and, thus, would not be governed by the cited Federal Trade Commission Act in respect of constituting unfair methods of competition in commerce; substantially meet the basic provisions of the above-quoted Revenue Ruling in respect of being normal, usual, and customary in the industry and in the community; are appropriate and helpful in obtaining business, and are made with the knowledge of the ship owners, the customers. Concerning the remaining phase as to whether the commission payments are made with

the consent of the owners of "tramp steamers", the operation and management thereof is such that the owners, in 97% of the cases, consist of 100 or more persons, each of whom owns an undivided interest; and, thus, the obtaining of specific formal consent from the many owners of a single ship, except in rare instances, would be impracticable, if not impossible, and, if obtained, from some individual owners would not be authoritative and binding on the other owners. The significance of the fact that the shipmaster, in his capacity of general manager, is duly clothed with all authority to bind the ship and or its owners for his acts while in foreign ports, in substance and in law, justifies the view that his singular position therein is tantamount to obtaining the consent of the owner or owners in respect of the commissions.

On the basis of the foregoing, the acts of the master of a "tramp steamer", in the above-indicated capacity, is sufficient to satisfy the requirements of Revenue Ruling 54-27, concerning the obtaining of the owners' consent; and, thus, the commissions in question paid by you, under the particular facts herein, would constitute ordinary and necessary business expenses, deductible from gross income under the provisions of section 162(a) of the Internal Revenue Code of 1954.

The other issue concerning whether the payments of said commissions are subject to withholding of tax under section 1441 of the Internal Revenue Code of 1954, upon which your letter requests a ruling, will be made the subject of a further communication subsequently hereto.

Very truly yours,
Russell C. Harrington
Commissioner (of Internal Revenue)